No. 17

IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

UNITED STATES OF AMERICA,

Petitioner,

v.

THE DONRUSS COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE SHAW-WALKER COMPANY AS *AMICUS CURIAE*

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Interest of The Shaw-Walker Company as *Amicus Curiae*

The issue in this case is the extent of the burden of proof a corporate taxpayer must carry to avoid the penalty of the accumulated earnings tax. This issue is before this Court not only in the *Donruss* case but also in *Commissioner of Internal Revenue* v. *The Shaw-Walker Company*, No. 95, October Term, 1968, in which the Government's Petition for Writ of Certiorari is now pending.

The Shaw-Walker Company has an immediate and vital interest in the resolution of this issue. In order to provide this Court with an opportunity to examine the issue in the light of the record in the *Shaw-Walker* case (which illuminates the practical consequences of the contentions of the parties in a way the record in *Donruss* does not), the Shaw-Walker Company moved on July 1, 1968 to consolidate the

two cases for argument. We understand this motion will be considered by the Court after the opening of the October Term. We also understand that the *Donruss* case has been scheduled for argument during the week of October 21, 1968. Being uncertain of the result of its motion for consolidation, and in order to present its views to the Court upon the issue here involved, Shaw-Walker respectfully submits this brief upon consent of the parties.

Statutes Involved

See Appendix to this Brief.

Question Presented

When tax avoidance is neither the "dominant", the "controlling", nor the "impelling" motive for a corporation's accumulation of all or a part of its earnings, may that corporation nevertheless be held to have been "availed of for the purpose of avoiding income tax with respect to its shareholders," under Sections 532 and 533 of the Internal Revenue Code of 1954, and therefore subject to the accumulated earnings tax?

Summary of Argument

The accumulated earnings tax is a penalty imposed wherever corporate earnings are accumulated to serve a manipulative scheme designed to avoid the income tax which would be imposed on shareholders if such earnings were distributed to them. The language of the statute, its legislative history and administrative interpretation, and, above all, the logic underlying its purpose and effect require the

conclusion that the tax may not be imposed unless tax avoidance is the "dominant", "controlling", or "impelling" motive for the accumulation, rather than the conclusion, urged by the Government, that the tax may be imposed even though tax avoidance is an incidental or subsidiary factor in the determination to retain a company's earnings. The "dominant purpose" test is supported by the decision of this Court in *Commissioner* v. *Duberstein*, 363 U.S. 278 (1960) and the better reasoned decisions of the courts of appeals.

The statutory presumption of tax avoidance purpose contained in Section 533(a) obviously gives the Government a significant advantage over the taxpayer in any accumulated earnings tax case. The issue in this case and the *Shaw-Walker* case is whether this presumption should be strengthened to such an extent as to give the Government a virtually conclusive advantage by forcing the taxpayer to prove, as the Government here demands, (Br., p. 18), a *total* absence of tax avoidance motive. Such a *per se* rule is contrary to the intent and purpose of the statute. The Government's claim that its proposed interpretation is required by administrative necessity is spurious.

ARGUMENT

A corporation is "availed of for the purpose of avoiding the income tax with respect to its shareholders" under the accumulated earnings tax provisions of the Internal Revenue Code only if tax avoidance was the "dominant, controlling, or impelling" motive for the corporation's retention of earnings.

A. Congress Intended the Accumulated Earnings Tax to be Imposed Only When a Corporation's Dividend Policy Is Dominated By a Manipulative Scheme to Avoid Income Tax on Its Shareholders

1. *Evolution of the statute*

Throughout their evolution, the statutory provisions imposing the accumulated earnings tax have been based on two fundamentally different factors: the accumulation of earnings beyond the needs of a corporate taxpayer's business, and the retention of earnings for the purpose of avoiding income taxes on the shareholders of a corporation. At its inception in 1913, the tax was assessed on shareholders of corporations "formed or fraudulently availed of for the purpose of preventing tax on the shareholders," and earnings accumulated beyond the needs of a corporation's business were "prima facie evidence of a purpose to escape such tax." Revenue Act of 1913, ch. 16, § (A)(2), 38 Stat. 114 (1913). In 1918 the word "fraudulently" was deleted, but only because the difficulty of proving common law fraud weighted the procedural balance too heavily in favor of the taxpayer. Ch. 18, § 220, 40 Stat. 1057 (1919), S. Rep. No. 617, 65th Cong., 3d Sess. 5 (1918).

Having previously shifted the tax from shareholders to their corporations, Congress in 1939 strengthened the presumption that accumulations beyond needs reflected the purpose of avoiding income taxes on the shareholders by making such accumulations "determinative of the purpose to avoid surtax upon shareholders unless the corporation by

the clear preponderance of the evidence shall prove to the contrary." Internal Revenue Code of 1939, § 102, 53 Stat. 35. When the statute became section 533(a) of the Internal Revenue Code of 1954, the word "clear" was omitted from the phrase describing the taxpayer's burden of overcoming the presumption.

The statute in both its earlier form and its present form has been construed as intended to impose the tax only when conventional corporate purposes are subordinated to tax avoidance purposes. The tax as it stood in 1921 was described thus:

> "No corporation which is actively engaged in business is to be subjected to the penalty of the statute unless and until it permits its course of conduct to be diverted from its normal business interests by a purpose to save its stockholders from surtax." *United Business Corp.* v. *Commissioner,* 19 B.T.A. 809, 828 (1930), *aff'd,* 62 F.2d 754 (2d Cir.), *cert. denied,* 290 U.S. 635 (1933).

In its opinion affirming the Board, the Second Circuit characterized the tax similarly, describing it as a tax aimed at "the manipulation of dividends." 62 F.2d at 756. Similarly, in *Electric Regulator Corp.* v. *Commissioner,* 336 F.2d 339, 346 (2d Cir. 1964), the court described the tax as it stood in 1957 as designed "to discourage . . . abusing the corporate form for the purpose of decreasing . . . personal tax liability. . . ."

Nothing in its evolution suggests that the statute in its present form is different from the 1913 statute in fundamental concept. Everything about its evolution suggests that the statute (which, after all, imposes the tax on a corporation availed of for "the" purpose of tax avoidance)

is aimed only at conduct which is warped out of its normal and legitimate course to serve the dominant antisocial purpose of manipulating corporate dividend policy to avoid personal income tax.

2. *Tax avoidance purpose and a corporate accumulation of earnings in excess of its needs are separate in concept and function.*

Both the courts and the Treasury's own regulations have consistently recognized that the two fundamental factors involved in the tax—accumulations beyond business needs and the purpose to avoid the tax on shareholders—are separate, and that either may be present when the other is entirely absent. Thus the courts have held that a corporation has not been availed of for the purpose of tax avoidance despite accumulation of its earnings beyond what were found to be the needs of the business. *E.g.*, *United States* v. *Duke Laboratories, Inc.*, 337 F.2d 280 (2d Cir. 1964); *T. C. Heyward & Co.* v. *United States*, 66-2 U.S.T.C. ¶ 9667 (W.D.N.C. 1966); *Bremerton Sun Publishing Co.* v. *Commissioner*, 44 T.C. 566 (1965). Correspondingly, the Treasury Regulations provided that a corporation would be subject to the tax if used for the purpose of tax avoidance even if accumulations were reasonable. Treas. Reg. 103, § 19.102-2 (1940) (regulations under Section 102 of the Internal Revenue Code of 1939).*

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* The rule is no longer applicable since section 535(c) of the Internal Revenue Code of 1954 reduces the quantum potentially subject to tax by any portion of a taxpayer's earnings reasonably accumulated for the needs of its business. However this change in result did not reflect any change in the fundamental structure of the statute. The quantum of earnings potentially subject to the tax was, in the 1939 Code and before, reduced by various items (*e.g.*, § 102 (d) (1) Internal Revenue Code of 1939) and the 1954 Code simply provided a similar and additional reduction for earnings retained for business needs.

In dealing with the accumulated earnings tax the courts have repeatedly stressed not only that the existence of unreasonable accumulations and of the purpose to avoid the tax on shareholders are separate questions, but also that the ultimate question is the purpose for which the corporation was used. *E.g., United Business Corp.* v. *Commissioner,* 62 F.2d 754, 755 (2d Cir. 1933). (L. Hand, J.); *Bremerton Sun Publishing Co.* v. *Commissioner,* 44 T.C. 566 (1965); *James M. Pierce Corp.* v. *Commissioner,* 38 T.C. 643 (1962), *acq.,* 1963-2 Cum. Bull. 5, *rev'd on other issue,* 326 F.2d 67 (8th Cir. 1964); *Pelton Steel Casting Co.* v. *Commissioner,* 28 T.C. 153 (1957), *aff'd,* 251 F.2d 278 (7th Cir.), *cert. denied,* 356 U.S. 958 (1958).

3. *The logic of the statute requires the "dominant purpose" test.*

As a penalty provision to deter the use of corporations as a device for avoiding taxes, the logic of the statute requires that the tax be assessed only where the purpose of avoiding shareholder taxes has a dominant force. Every human action has the "purpose" of bringing about any consequence which inevitably flows from it. *See, e.g., People* v. *Jernatowski,* 238 N.Y. 188 (1924); *People* v. *Nichols,* 230 N.Y. 221 (1921); *see also Osborne* v. *Montgomery,* 203 Wis. 223, 234 N.W. 372 (1931); *In re Polemis,* [1921] 3 K.B. 560. Putting a prosperous business into corporate form or continuing a prosperous business in that form almost inevitably has a tax avoidance "purpose" to some degree since the owners of prosperous businesses are usually people whose income taxes would be increased if they received the earnings of the business directly. However, the statute clearly does not strike at such actions so long as the legiti-

mate business purposes* to be served by them are dominant and the avoidance of shareholder taxes necessarily following from them is incidental. Rather, application of the tax must depend on subordination of legitimate corporate activities to the goal of tax avoidance.

The conclusion that the logic of the statute requires assessment of the tax only when tax avoidance is the "dominant, controlling, or impelling" purpose of accumulations has been reached by the Sixth Circuit below (and subsequently in *Shaw-Walker Company* v. *Commissioner*, 390 F.2d 205 (6th Cir. 1968); *petition for certiorari pending No. 95 this Term*) and by the First Circuit in *Young Motor Co.* v. *Commissioner*, 281 F.2d 488, 491 (1st Cir. 1960). The First Circuit recognized that the simplistic rule the Government now seeks would result in virtually every solvent corporation being chargeable with the proscribed purpose:

> "The Tax Court may have been led into this error by a misconception of the precise issue. In its opinion it referred to preventing the imposition of the surtax upon stockholders as 'one' of taxpayer's purposes, and stated, 'If this purpose exists it may be accompanied by other legitimate business objectives and still the statute will apply.' The court discussed at some length that taxpayer, being controlled by Young, must be taken to have known that declaring dividends would increase Young's surtaxes—a proposition scarcely requiring argument. If knowledge of such a result is to be the test of purpose, then the only corporations that could safely accumulate in-

* *E.g.*, insulation of owners against tort liability; centralizing management for efficiency; preventing minor or incompetent members of a family from meddling in management; facilitating administration of the estates of owners; facilitating gifts or sales of interests in the business; facilitating borrowing by the business.

> come would be those having stockholders with substantial net losses. The statute does not say 'a' purpose, but 'the' purpose. The issue is not what are the necessary, and to that extent contemplated consequences of the accumulation, but what was the primary or dominant purpose which led to the decision. *Cf.* Commission of Internal Revenue v. Duberstein, 1960, 363 U.S. 278, 80 S. Ct. 1190, 4 L.Ed.2d 1218."

Both the First and Sixth Circuits saw parallels in cases in which this Court has held that determination of the "purpose" underlying an act requires detailed examination of all the facets of that act, requires striking a balance between the conflicting inferences to be drawn from them and then requires categorizing the act in terms of that balance. In *Commissioner* v. *Duberstein,* 363 U.S. 278 (1960), this Court rejected the Commissioner's argument that the question whether a transfer between persons having a business relationship was a gift or a payment for services should be decided by presuming that such transfers could not reflect the type of intent requisite to a gift. The Court refused to limit investigation into the intent behind transfers of property in this arbitrary manner, holding that

> "... the proper criterion, established by decision here, is one that inquires what the basic reasons for his [the taxpayer's] conduct was in fact—the dominant reason that explains his action in making the transfer." 363 U.S. at 286.

Recognizing the wide variety of motives which might affect any disposition of one's property, this Court held that findings of fact as to an individual's purpose must be based not on any mechanical rule, but

> ". . . ultimately on the application of the fact-finding tribunal's experience with the mainsprings of

> human conduct to the totality of the facts of each case." 363 U.S. at 289.

The decision in *Duberstein* was a restatement of doctrine this Court had enunciated earlier in cases holding that transfers of property are made "in contemplation of death" within the meaning of the estate tax statutes only if the dominant, controlling, or impelling motive for the transfer was awareness of approaching death. *Allen* v. *Trust Company of Georgia*, 326 U.S. 630, 636 (1946); *City Bank Farmers Trust Co.* v. *McGowan*, 323 U.S. 594, 599 (1945); *United States* v. *Wells*, 283 U.S. 102, 118 (1931).*

The Sixth Circuit in this case referred to these decisions and applied the same criteria in construing the accumulated earnings tax:

> "In our view there is no sound reason why the 'dominant, controlling, or impelling' motive test employed in connection with the gift in contemplation of death provision should not be applied to the accumulated earnings tax provision. Both provisions have as their underlying purpose the prevention of tax avoidance which is made possible by the structure of the income tax laws. Neither provision explicitly sets out the extent to which the proscribed purpose must play a part in the transaction

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* The Government argues that differences between the accumulated earnings tax and the gift and estate taxes make analogies between them inappropriate, stating: "In Duberstein, this Court was unwilling to draw on precedents based on other provisions of the tax code" (Br., p. 5). However, in the passage in *Duberstein* to which the Government refers to support this assertion, this Court was not considering whether the method of inquiring into "purpose" where that is decisive under one portion of the Code should be employed where "purpose" is decisive under another. It only said there was little value in looking to gift tax and estate tax provisions of the Code for enlightenment on the "meaning of the term 'gift' as applied to particular transfers" for purposes of the income tax. 363 U.S. at 284.

> or conduct in order for the tax consequences to attach. To hold that the dominant, controlling, or impelling motive criterion is inapplicable in the case of the accumulated earnings tax provision would require that we make a distinction where no material difference exists."

Indeed, application of the rule that "the purpose" of a taxpayer's use of property must be the dominating or impelling purpose (rather than a subsidiary motive or incidental result) is more appropriate in the accumulated earnings tax area than in the gift and estate tax areas, because the accumulated earnings tax is a "penalty" on "improper" utilization of corporations for the purpose of tax avoidance. See *Helvering* v. *National Grocery Co.*, 304 U.S. 282, 288-89, 290 (1938). As such it should not be imposed where tax considerations are incidental to legitimate business purposes.*

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* The Government's suggestion that *Spies* v. *United States*, 317 U.S. 492 (1943), provides an analogy supporting its position is completely unfounded. The question in that case was whether a taxpayer who "willfully failed to make a return of taxable income" (a misdemeanor under Section 145(a) of the Revenue Act of 1936) and "willfully failed to pay the tax due on his income for that year" (a second misdemeanor under the same statute) could be held guilty of the third crime (a felony under Section 145(b) of the Act) of willfully attempting "in *any* manner to evade or defeat" the same income tax if nothing more was shown. 317 U.S. at 493-94. (Emphasis added.) This Court reversed a decision that the taxpayer could be convicted on this basis. It held:

> "We think that in employing the terminology of attempt to embrace the gravest of offenses against the revenues, Congress intended some willful commission in addition to the willful omissions that make the list of misdemeanors." 317 U.S. at 499.

The whole point of the decision was that conviction of a felony depended on there being an act unequivocally directed to the particular purpose proscribed by Section 145(b), the purpose of evasion. The Court went on to note, in the words quoted by the Government (Br.,

4. The Treasury's regulations presuppose the "dominant purpose" test.

The Treasury's regulations have always implied that a corporation's dividend policy must be dominated by a scheme to reduce the income taxes of shareholders if the tax is to be imposed. The regulations under the 1954 Code provide that:

> (a) The presence or absence of "the purpose to avoid income tax with respect to the shareholders" can be evidenced by factors other than those indicating simply the existence of an accumulation of earnings beyond the needs of a taxpayer's business.*
>
> (b) To determine whether the requisite tax avoidance purpose is present, "the particular circumstances of each case" must be examined.
>
> (c) The following specific factors must be considered in this examination:
>
> (i) any withdrawal of funds from the corporation as loans to shareholders;
>
> (ii) any expenditure of funds by the corporation for the personal benefit of shareholders;

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p. 15), that once a course of action unequivocally directed to the purpose proscribed by the statute had been shown, it was irrelevant whether it also had another legal significance. If a valid analogy could be drawn from *Spies* (which seems dubious), it would appear to point to the conclusions (i) that a corporation could be held subject to the tax only if it took a course of affirmative action unequivocally directed to avoiding tax on its shareholders and (ii) that such a course of action would cause the tax to be imposed even though it had a dual legal significance, such as avoiding state income tax on the same shareholders.

* "The existence or nonexistence of the purpose to avoid income tax with respect to shareholders may be indicated by circumstances other than the conditions specified in section 533." Treas. Reg. § 1.533-1(a)(2)(1959).

(iii) any investment of funds by the corporation in assets unconnected with its business, and

(iv) the extent to which the corporation has distributed its earnings.

(d) All the specific factors to be examined in a particular case cannot be enumerated in advance, and those listed in the regulations are only those to be examined "among other things." Treas. Reg. § 1.533-1(a)(2) (1959).

The regulations under statutes prior to the 1954 Code were of the same tenor.* The regulations under the Internal Revenue Code of 1939 are substantially the same as those under the 1954 Code.

The whole thrust of the regulations is fundamentally inconsistent with the Government's argument here. Going backwards in time, fewer and fewer of the phrases now present in the regulations can be discerned. For example, compare Article 542, Regulation 77 (1933) with Article 102-2, Regulation 86 (1935). As it has elaborated its regula-

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* Regulations 118, § 39.102-2 (1953); Regulations 111, § 29.102-2 (1943); Regulations 103, § 19.102-2 (1940) (all under the Internal Revenue Code of 1939, § 102);
Regulations 101, Art. 102-2 (1939) (Revenue Act of 1938, § 102);
Regulations 94, Art. 102-2 (1936) (Revenue Act of 1936, § 102);
Regulations 86, Art. 102-2 (1935) (Revenue Act of 1934, § 102);
Regulations 77, Art. 542 (1933) (Revenue Act of 1932, § 104);
Regulations 74, Art. 542 (1929) (Revenue Act of 1928, § 104);
Regulations 69, Art. 352 (1926) (Revenue Act of 1926, § 220);
Regulations 65, Art. 352 (1924) (Revenue Act of 1924, § 220);
Regulations 62, Art. 352 (1922) (Revenue Act of 1921, § 220);
Regulations 45 (1920 Edition), Art. 352 (1921) (Revenue Act of 1918, § 220);
Regulations 45, Art. 352 (1919) (Revenue Act of 1918, § 220);
Regulations 33 (Revised), Art. 19 (1918) (Revenue Act of 1917, § 2).

tions over the decades, the Treasury has indicated with increasing clarity an awareness that the tax avoidance purpose proscribed by the statute is a manipulative purpose which dominates corporate dividend policy.

Regulations embodying the Government's approach would state that a single inference of a tax avoidance purpose drawn from examining *any* aspect of a corporation's activities would establish the tax avoidance purpose at which the statute is directed. However, the regulations do not so provide. Rather, by requiring the examination of *all aspects* of company policy, the regulations indicate that a finding as to the existence or absence of the proscribed purpose requires balancing all the inferences to be drawn from all the facets of corporate activity and of corporation-shareholder relationships to determine whether or not the purpose of avoiding taxes was predominant. If, as the Government argues, a corporation should be considered to have been availed of for the purpose of tax avoidance in the sense of the statute whenever tax avoidance can be inferred from *any* facet of its policy, the admonition of the regulations to examine *all* facets of its policy is meaningless.

5. *The cases cited by the Government do not support its construction of the statute.*

The Government asserts repeatedly that, in *Helvering* v. *Chicago Stock Yards Co.*, 318 U.S. 693 (1943), this Court construed the statutory predecessor of the present Code provisions as imposing the accumulated earnings tax on any corporation if its management entertained any purpose of tax avoidance whatever, even though that purpose was not a decisive factor in the operation of the company.

(Br., pp. 6, 7, 10, 11, 15, 19, 21, 25) But this Court did not conceive the *Stock Yards* case as presenting any such question, and the Government completely misconstrues the portion of the *Stock Yards* opinion it so frequently quotes.

The Board found the Stock Yards company to be "Prince [its sole shareholder] in corporate clothes." 41 B.T.A. 590, 621. The Board explicitly held that the sole purpose of the company's retention of earnings, indeed the sole purpose of its existence, was tax avoidance:

> "It was of no moment to Prince whether the earnings of the petitioner were carried in his individual pocketbook or in his corporate pocketbook, except that if they had been received in the first instance in his individual pocketbook or distributed to him by the petitioner he would have been subjected to heavy surtaxes upon them, while he avoided such surtaxes by retaining them in the corporation." *Ibid.*

The Court of Appeals reversed the Board's decision imposing tax and remanded for further consideration. *Chicago Stock Yards Co.* v. *Commissioner*, 129 F.2d 937 (1st Cir. 1942). This Court reversed the Court of Appeals and reinstated the decision of the Board. This Court's opinion makes three points, none of which support the Government's strained construction of the statute.

The first point disposed of the contention that, since the company's accumulation plan originally had no tax significance, its continuance could not properly be characterized as a tax avoidance device within the meaning of the statute. This point was couched in the words much quoted in the

Government's brief in the case at bar,* but the words were not directed to the question posed here, which had not been raised by the parties in the Supreme Court. In the quoted passage the Court said only that a plan begun in pre-tax years and extended into taxable years could justifiably be treated by the Board as being a tax avoidance scheme within the meaning of the statute during the later years. This Court did not consider whether a recognition of tax avoidance in corporate planning could be the basis for imposing the earnings tax when tax avoidance was not a dominant factor in that planning.

The second and central point in the *Stock Yards* opinion was that the Board was justified in its conclusion that the sole purpose of the plan during the later years was tax avoidance. This portion of the opinion summarizes the accumulation plan and its effects and holds that "although Mr. Prince denied any purpose to avoid surtaxes, the Board . . . was free to conclude, upon all the evidence, that such was the purpose." 318 U.S. at 701.

This Court's final point was that the Board's conclusion was not subject to judicial review because:

> "We cannot say that the Board's conclusion that respondent was availed of for the purpose of preventing the imposition of surtax upon its stockholders . . . is without substantial support." 318 U.S. at 702.

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* "A corporate practice adopted for mere convenience or other reasons, and without tax significance when adopted, may have been continued with the additional motive of avoiding surtax on the stockholders. The Board's conclusion may justifiably have been reached in the view that, whatever the motive when the practice of accumulations was adopted, the purpose of avoiding surtax induced, or aided in inducing, the continuance of the practice." 318 U.S. at 699.

This ultimate holding reflects the fact that, between 1926 and 1948, the powers of courts of appeals to review decisions of the Board of Tax Appeals and the Tax Court were sharply limited by statute.* As a result of this limitation on appellate review, this Court held in *Dobson v. Commissioner*, 320 U.S. 489, 501-02 (1943), that when an appellate "court cannot separate the elements of a [Tax Court] decision so as to identify a clear-cut mistake of law, the decision of the Tax Court must stand."

The Board found that tax avoidance was the sole purpose of the taxpayer in *Stock Yards*, and there could be no doubt the tax was properly imposed under any rule of law after this finding. This Court had no occasion in *Stock Yards* to consider what was the proper construction of the "purpose" clause in the accumulated earnings tax provisions, and did not do so. It examined the two conclusions the Board actually reached; first, the conclusion that a pre-tax plan continued during a taxable period could be a tax avoidance device, and, second, the conclusion that the Stock Yards company was nothing but a tax avoidance device. This Court did not purport to hold that the decision

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* The Revenue Act of 1926, in § 1003(a), vested exclusive jurisdiction to review decisions of the Board of Tax Appeals in the courts of appeals, and restricted any review of issues of fact, providing:

> "Upon such review, such courts shall have power to affirm or, *if the decision of the Board is not in accordance with law*, to modify or to reverse the decision of the Board . . ." § 1003(b), 44 Stat. 110. (Emphasis added.)

The 1939 Internal Revenue Code in §§ 1141(a), (c) adopted the same provisions. 53 Stat. 164 (1939). Section 36 of the Act of June 25, 1948, again vested exclusive appellate jurisdiction of Tax Court decisions in the courts of appeals but provided that such review should be coterminous with the scope of review in federal civil nonjury actions. Act of June 25, 1948, Ch. 646, § 36, 62 Stat. 991. The 1948 amendment is now Section 7482 of the Internal Revenue Code of 1954.

of the Board was correct because the tax it imposed could have been properly imposed even if the Board had reached some different conclusion (for example, a conclusion that reducing Prince's tax was contemplated by the directors of Stock Yards but was not of decisive force). The *Stock Yards* case is irrelevant to the question presented here and does not support the Government's position.

The Government also relies on *Trico Products Corp.* v. *Commissioner*, 137 F.2d 424, 426 (2d Cir.), *cert. denied*, 320 U.S. 799 (1943) for its view that the Second Circuit has rejected the "dominant purpose" test. That decision, however, was premised on an interpretation of the *Stock Yards* case as a holding that the "dominant purpose" test was not correct, an interpretation which, for the reasons given above, we submit is erroneous.

The Government repeatedly refers to *Barrow Mfg. Co.* v. *Commissioner*, 294 F.2d 79 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962), as adopting the "any purpose" test (Br., pp. 19, 23-24, 26). It is submitted that the rationale of this decision is obviously erroneous and that it should be overruled. It rests on the premise that, if the tax may be imposed only when a corporation's dividend policy is dominated by a scheme to avoid taxes, the Section 533(a) presumption created by a determination that earnings have been accumulated beyond needs "is well nigh destroyed if that presumption in turn is saddled with requirements of proof of 'the primary or dominant purpose' of the accumulation." 294 F.2d at 82. This turns the statute completely around. The presumption functions after it is determined that earnings have been retained beyond needs. At that point it is the taxpayer who must prove a negative—the

lack of a dominant intent to avoid taxes—not the Government, in whose favor the presumption runs.

Finally, the Government incorrectly ascribes to the Eighth and Tenth Circuits agreement with its position. These courts in *World Publishing Co.* v. *United States*, 169 F.2d 186, 189 (10th Cir. 1948), *cert. denied*, 335 U.S. 911 (1949), and *Kerr-Cochran, Inc.* v. *Commissioner*, 253 F.2d 121, 123 (8th Cir. 1958) held that the tax may be imposed when tax avoidance was "one of the determinating" motives of an accumulation. Although the Eighth and Tenth Circuits did not discuss the degree of importance a purpose must have to be a "determinating" purpose, the Tenth Circuit's view was that:

> "In all such cases as this, no single factor can be pointed to as controlling. A correct answer can be reached [on the question of whether there was a determinating purpose to avoid tax] only in considering all of the facts and circumstances of the particular business under consideration and of the owner or owners of such business." 169 F.2d at 189.

Contrary to the Government's contention, these cases do not support its position, but rather suggest, as we urge, that a balancing of the taxpayer's various motives for accumulating earnings is required before one can decide whether tax avoidance was a "determinating" motive. At minimum, it seems clear that a purpose which is "determinating" in the sense of the opinions of the Eighth and Tenth Circuits must be one which contributes substantially to the decision to retain earnings, while the Government contends here that any inference of a tax avoidance motive, no matter how slight, provides a basis for the tax.

B. The Government's Interpretation Would Incorrectly and Unrealistically Impose a *Per Se* Rule, Inconsistent With Section 533(a), That the Tax Be Imposed Whenever It Is Determined That a Corporation Has Accumulated Earnings Beyond the Needs of Its Business.

The Government argues that the accumulated earnings tax must be applied "unless there is a *complete absence* of tax avoidance motive for an unreasonable accumulation" (Br., p. 18; emphasis added), and that the tax must be imposed " . . . except in those unusual cases where the trier of facts is persuaded that tax avoidance played *no part* in inducing the unnecessary accumulation." (Br., p. 21; emphasis added.) This interpretation is not only wrong in view of the plain meaning of Sections 531 through 533(a), their legislative history, and their administrative interpretation, but because it would require a taxpayer to carry a burden of proof which it could never, in practice, carry—the burden of proving that considerations of tax consequences to shareholders were entirely absent from the minds of the corporate managers whose decisions led to the accumulation of earnings.

It is a commonplace that the actual or possible effects of federal income taxes are routinely recognized by managers framing corporate policy.* In family corporations or other closely held companies it is impossible to imagine that, in deliberations about distributing dividends, there could humanly be the "complete absence of tax avoidance

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* See *Young Motor Co.* v. *Commissioner*, 281 F.2d 488, 491 (1st Cir. 1960), *supra* pp. 8-9, and the observation of Judge Learned Hand in *Commissioner* v. *National Carbide Corp.*, 167 F.2d 304, 306 (2d Cir. 1948), *aff'd*, 336 U.S. 422 (1949), that "in a society like our own . . . business is always shaped to the form best suited to keep down taxes"; see also *Commissioner* v. *Tower*, 327 U.S. 280, 288-89 (1946); *A. E. Green Export Co.* v. *United States*, 284 F.2d 383, 389-90 (Ct. Cl. 1960).

motive'' of the sort the Government demands. This is particularly obvious when it is recognized that the Government would couple its construction of Section 533(a) to the assertion that a corporate management's recognition of the tax consequences to its shareholders which would follow from distributing a dividend implies a tax avoidance purpose. By doing this, the Government would convert a rebuttable presumption into a *per se* rule which would almost inevitably charge any family owned or other closely held corporation with the tax avoidance purpose proscribed by the statute.*

A definition of purpose which gives the taxpayer a meaningful opportunity to rebut the presumption is particularly important under the accumulated earnings tax provisions of the Code. A finding of unreasonable accumulation, while clearly of evidentiary weight on the question of purpose, is not logically inconsistent with an absence of intent by a corporation to avoid taxes on its shareholders. The accumulation may, of course, reflect the proscribed purpose,

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* The Government argued, for example, in *Shaw-Walker* and *Young Motor* that, if the controlling shareholders of a corporation would have had to pay additional income tax as a result of an increase in its dividends, the inference that earnings were accumulated for the proscribed purpose must be drawn. The Tax Court expressly found in *Shaw-Walker* that none of the factors specified in the Treasury Regulations as indicative of the purpose of tax avoidance were present. *Shaw-Walker Company* v. *Commissioner*, 390 F.2d 205, 215-16 (6th Cir. 1968). The record in *Shaw-Walker* includes substantial additional, and undisputed, evidence that the company was not managed for tax avoidance purposes. (See the references to the record in Shaw-Walker's Response to the Petition for Writ of Certiorari, No. 95, October Term, 1968 at pp. 3 and 6.) The Government's decision to petition for certiorari in *Shaw-Walker* on the record in that case demonstrates that it views its "any purpose" test as having the practical effect of imposing the tax whenever accumulations of earnings are held to exceed the reasonable needs of a corporation the shareholders of which are subject to substantial federal income tax.

but it may also simply reflect a mistake in judgment on the part of management or a difference in judgment between management and the fact finder on the question of the reasonable needs of the corporation. See *Electric Regulator Corp.* v. *Commissioner*, 336 F.2d 339, 346-47 (2d Cir. 1964).

Under the Government's strained interpretation, the slightest evidence that corporate executives considered the possible tax consequences of a dividend upon the shareholders would be fatal to any claim by the taxpayer that an accumulation was made in good faith, though there is substantial objective evidence of this. The Government's interpretation would render meaningless the taxpayer's right under Section 533(a) to disprove the statutory presumption that the accumulation was improper and would effectively delete from Section 533(a) the "unless" clause which gives a taxpayer the right to rebut the presumption. Certainly there is no evidence in the legislative history of the accumulated earnings tax that Congress, in enacting Section 533(a) and its predecessors, intended a taxpayer's right to rebut this presumption to be illusory. The accumulated earnings tax is, as the courts have held and the Government concedes (Br., p. 15, footnote), a penalty tax rather than a usual income tax. It is submitted that in a situation such as this involving a penalty, legislative intent to deprive a taxpayer of the right of rebuttal should not easily be inferred. The Government's position should be rejected as unfair and impractical.

C. The Government's Claim that It Requires the "Any Purpose" Test to Enable It to Enforce the Revenue Laws Properly is Spurious

The Government's alleged justification for the unrealistic rule which it proposes is that:

> ". . . such questions of intent are not satisfactorily tried on the basis of the self-serving, after-the-fact, trial testimony of the corporate managers" (Br., p. 19);

and that

> "Assessment of the relative importance and priority of several motives is even more difficult. Generally no evidence would be available other than the trial testimony of corporate managers that in their minds any thought of tax avoidance was no more important than (or was subordinated to) other objectives. There will rarely be objective evidence by which such claims may be tested" (Br., p. 22);

and that

> "The taxpayer may rest on unchallengeable and entirely unprovable assertions of state of mind, and no longer need 'disclose the facts' (62 F.2d at 756) that corroborate his assertions." (Br., p. 23)

This claim of administrative inconvenience rests on an apparent misunderstanding of the statutory scheme (which contains a presumption strongly favoring the Government), a seeming lack of awareness of the extensive fact-gathering machinery available to the Government, and a total lack of sympathy for the principle, basic to our system of law, that courts and juries are competent to decide issues of fact. The argument ignores the fact that issues of motive, intent and purpose are routinely tried in criminal pro-

ceedings and in a variety of civil actions, such as fraud cases, in courts in every state. It is fair, we submit, to assume that many of these cases involve situations as complex as those which may be found in accumulated earnings tax cases. Yet courts and juries do decide such issues without the need to constrict, as the Government suggests here, established defenses and rules of evidence to the point of practical uselessness.

Throughout the Government's brief, it is implied that the question of the presence or absence of a "dominant purpose" of tax avoidance must necessarily be determined on *viva voce* testimony consisting of the corporate management's assertions about its several and collective states of mind. This entirely ignores the long-standing Treasury regulations which provide that the purpose issue under Sections 531 *et seq.* of the Code is to be tried under "principles applicable to income tax cases generally." Treas. Reg. § 1.533-1(b) (1959). These principles are conventional rules of evidence.* The Government's argument also ignores the fundamental rule that any subjective state is subject to proof by direct or circumstantial objective evidence.

What is true of the rules of proof with respect to any subjective state is equally true of the rules with respect to proving relative weight or priority where a variety of subjective motives are present or assertedly present. The Treasury's own regulations (pp. 12-13, *supra*) provide that objective evidence of financial transactions in various categories are all to be examined for the inferences which

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* Proceedings in the Tax Court are to be tried under the rules of evidence applicable in trials without a jury in the District Court for the District of Columbia. Internal Revenue Code of 1954, § 7453. Actions for refund are, of course, tried under the Federal Rules of Civil Procedure applicable to all federal civil litigation.

can be drawn from them respecting the presence or absence of the proscribed purpose. These regulations demonstrate the groundlessness of the fears voiced by the Government concerning the nature of the proof which will be offered and the difficulties of assessing this proof if the taxpayer's construction of the statute is accepted.

The Government's further assertion that the taxpayer need not disclose the facts and can rest on glib, self-serving statements by corporate managers is equally unfounded. Central to the statutory scheme is the fact that the Government receives the benefit of the presumption created by Section 533(a) and that it is the taxpayer, not the Government, which is saddled with the burden of rebutting that presumption and of coming forward with evidence to disprove the presence of the proscribed purpose. This statutory burden is a heavy one to meet; it should not be increased, as the Government urges, to the point where it makes the taxpayer's rights illusory and prevents the taxpayer from ever, in practice, proving that it was not functioning to serve a scheme of manipulation.

In addition to the advantage conferred upon it by the statutory presumption, the Government has the benefit of extremely broad powers of discovery into the facts. In addition to discovery and subpoena powers accorded under the Federal Rules of Civil Procedure which are available in refund suits, Sections 7602 through 7608 of the Internal Revenue Code of 1954 grant unusually broad authority for the examination of books, records and witnesses by the Internal Revenue Service. The breadth and strength of the Government's powers to gather facts under these provisions have been emphasized in recent decisions such as those in *United States* v. *Powell*, 379 U.S. 48 (1964), *United States*

v. *McKay*, 372 F.2d 174 (5th Cir. 1967), and *DeMasters* v. *Arend*, 313 F.2d 79 (10th Cir.), *cert. denied*, 375 U.S. 936 (1963).

In view of these powers, the Government's claim that it will be unable to meet "self-serving" testimony of corporate managers who need not "disclose the facts" is without substance. Long prior to the trial of an accumulated earnings tax case, the Government has available for its examination every scrap of documentary proof and is free to examine all necessary witnesses. The evidence it develops is available not only for purposes of impeachment, but also as substantive evidence of proscribed purpose to rebut evidence the taxpayer offers. The availability of such fact-gathering devices, coupled with the statutory presumption favoring the Government under Section 533(a), clearly gives the Government a very considerable advantage in any accumulated earnings tax case. There is no rational basis for the argument advanced by the Government in this case that effective administration of the tax is impossible under the construction of Section 533(a) employed by the Sixth Circuit in the *Donruss* and *Shaw-Walker* cases.

CONCLUSION

It is respectfully urged that this Court affirm in all respects the judgment of the Court of Appeals.

Respectfully submitted,

Dated: New York, New York
August 10, 1968

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